DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15196
San Diego, California

40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

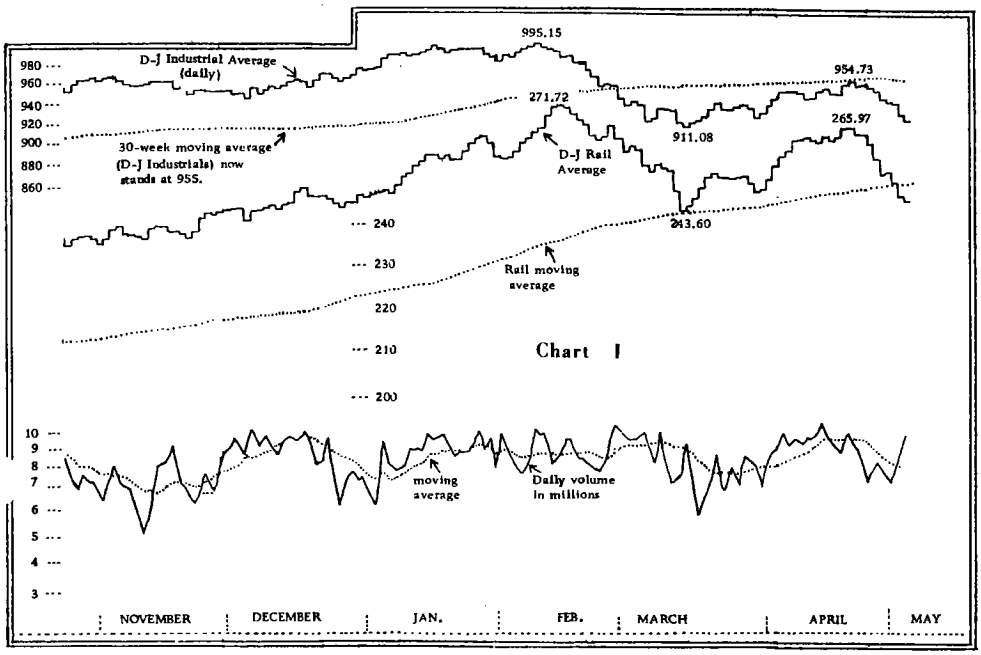
May 4, 1966 Letter 322

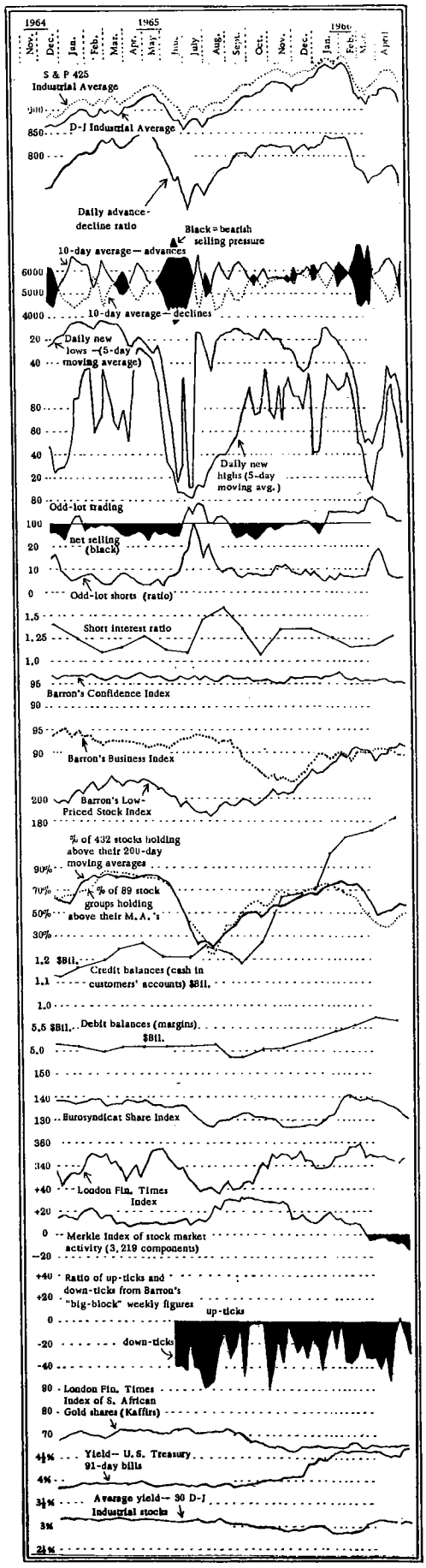
THE MARKET: For almost a year the American public has been told that no economic trouble could be expected while the nation was engaged in an expanding war in Asia. For over a year the public has been told that the "pressures of inflation" would insure prosperity and a trend of rising prices on Wall Street. For many years the public has been bolstered by the theory that "built-in stabilizers" would prevent trouble and that the "Government would not allow anything to happen." In the face of widespread complacency and rising speculative enthusiasm, the big stocks, the blue-chip backbone of the economy issues, have been creaking steadily lower. Despite intense speculation in many war-related equity groups, informed investors have been distributing the quality issues under the smokescreen of rising speculative confidence.

Over and over again in Letter after Letter I have been urging my subscribers to use their heads and try to "see through" the camouflage of propaganda and wishful thinking which has enveloped the country. In Letter 318 I presented eight reasons why I thought my subscribers should "clean house" and move into a position of approximately 80 to 85% cash (Treasury bills) and 15 to 20% gold shares. I have repeated ad nauseum to subscribers that bull markets end when the best that can be seen ahead is fully discounted in the Averages and when the business and corporate news is fairly glowing with hopefulness and confidence.

In Letter 320 I pointed out that for the first time in seventeen years or since the great bull market started at 161.60 in 1949, the D-J Industrial Average and the Low-Priced Stock Index parted ways during a reaction. Even while the Dow was being ripped by an 84-point decline, the Low-Priced Stock Index had risen into new high ground. Always before, the two Averages had reacted together.

In Letter 321 I included a chart showing that Standard & Poor's High-Grade Stock Index was in a bear market, having topped out in early 1965. Small wonder then that Wall Street has gone along wholeheartedly with the inflation and guaranteed prosperity theme. It is only normal to "talk up" your product when you want to sell it. And when you have a lot of product to sell, you need a big market. It takes a lot of "big talk" and speculation to make a big market. The 1965-66 market has been the largest volume market in history and it has been characterized by some of the




1964
1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

wildest speculation in a generation.

It should be remembered that it requires large "investment interests" to support a falling market. But for over a year large investment interests have been selling, not buying, and this is the reason the high-grade issues have been going down. Seasoned investors, men who buy values, have been "putting their houses in order" while traders, speculators and many funds have been loading up on "high flyers." But in most cases the high flyers have been purchased as speculations, not values. They have been bought and held via the charts and computers, and often for no other reason than that they were going up. Thus we cannot expect the people who hold the high flyers to support the market. These speculators want profits not more shares, and when the stocks they bought go down the rationale for holding these shares goes with them. Thus, we have all the elements which go into making a major bear market, large investment interests liquidating while a transient public and in-and-out speculators are loaded with inflated shares selling at price-earnings ratios of 30 to 100.

* * *

During late April the Industrial Average rallied to test the halfway level of the February-March decline (see last Letter). The Dow failed to hold decisively above either the halfway level (953.12) or the 30-week moving average (now 955 and beginning to move down). A decline began on April 24. On May 2 the Dow broke below the halfway level of the March-April rally, a feat which the Rails had already accomplished three days earlier. On May 3 Rails broke through their own moving average (see chart 1), and this is an act which Rails had avoided at the March lows.

NOTES AND QUOTES: "April was the worst month in the history of the industry," said A. M. Frank of California's State Mutual Savings & Loan Association. Frank was referring to the fact that in April the S & L industry lost about $400 million in deposits. This money went to the competition, which in the main was bank certificates of deposit at whopping rates of 5½%. Many of the California S & L associations are now "loaned up." They have no more money for mortgages. Where mortgage money is available, it is going at 7 and 7½%.

But the next major package of trouble is not coming from the bank competition. It is coming from the "King Spender" of them all, Uncle Sam. President Johnson's 1967 budget is to show a $6.5 billion deficit. To cut this deficit to $2 billion or less, the Administration has conjured up a bookkeeping plan. They are going to sell Government loans and thus reduce expenses. The Government holds about $33 billion in loans made to farmers, small businessmen, colleges, etc. The new plan is to sell these loans through a Government "pool." The loans will all be lumped together and sold as so-called "certificates of participation." Distribution of the certificates will be through the Federal National Mortgage Association.

The certificates will be sold to institution and individuals with the latter being able to buy certificates for as little as $1000. Interest paid on these certificates will probably run from 1/4 to 1/2% above regular bond rates. Interest will be paid twice a year and will be called dividends. If Congress votes in this latest gimmick, the banks, S & L's and all savings institutions will have a new and high-powered source of high-interest competition. In the view of a few observers, the certificates will serve to set off a liquidity crisis in the S & L's. It promises to be an exciting time in 1966.

* * *

The accompanying clipping points up an ominous threat to the current U.S. boom. At the same time, U.S. News & World Report (May 2) reports: "Car imports are heading into the 'wild blue yonder.' Last year 559,000 cars were imported. The record, set in 1959, was 668,000. This year, 800,000 are expected." From Ward's Automotive Reports come these amazing facts: Canada is now exporting more cars than the U.S., Volkswagon's sales for the first quarter are up 50% over last year. Seven producers overseas each now produce as many cars as Amer. Motors did at its peak.

* * *

There are about 100,000 millionaires in the U.S. That the stock market exerts a major effect on this influential group is shown by the following statistics. The millionaires hold their assets in these catagories: Corporate stocks 65%, tax-exempt bonds 8.5%, real estate 6.7%, cash 4.3%, U.S. Government bonds 4.2%, mortgages and notes 1.8%, insurance 1.8%, misc. 7.7%.

* * *

From James Reston's April 29 column in the N.Y. Times: (The column is about Hubert Humphrey) "Anybody who goes all out for the President when the President is in trouble is sure of his support, and Humphrey has almost certainly assured his nomination as Vice-President in 1968. .... Nevertheless, he is in trouble, for he has not used his opportunities in the Vice-Presidency to establish himself as the natural successor to Johnson as the leader of his party. If anything, he is further from that goal than he was when he was elected.....It is all too bad. This was the mind that was more creative than almost any other in the Senate in the fifties, but it is scattered now in an endless tangle of little chores, ceremonial greetings, and repetitive political arguments."

* * *

The second clip (left, above) tells the story of the latest desperate act by our sister spendthrift nation. It would seem that the U.S. and Britain are now vying with each other in producing new monetary and gold-saving gimmicks. Europe is showing less and less interest in our pathetic machinations. For instance, the cover story from today's U.S. News & World Report (May 9) in entitled: "Is Europe Pulling Away from America?"

* * *

From Senator J.W. Fulbright's speech last week regarding Vietnam, guns and butter: "My own view is that there is a kind of madness in the facile assumption that we can raise the many billions of dollars necessary to rebuild our schools and cities and public transport and eliminate the pollution of air and water while also spending tens of billions to finance an 'open-ended' war in Asia."

BRITAIN ACTS TO SAVE GOLD

Dow Jones News Service

LONDON — The Labor government yesterday issued an order forbidding the use of gold in manufacture of medals and similar items and restricting the right of United Kingdom residents to hold more than four gold coins minted after 1837, except with official permission.

The move was made, the government said, to prevent losses in British gold reserves. Medals made for export and for use as academic and sporting awards are exempt from the ruling.

PAYMENTS THREAT SEEN

WASHINGTON (AP) — The Commerce Department yesterday projected further shrinkage this year in the favorable U.S. trade balance to $4.7 billion, a factor that could spell trouble for Administration efforts to end a deficit in the U.S. balance of payments.

The trade balance dropped last year to $5.1 billion from about $7 billion in 1964.

For the first three months of this year, the Commerce Department reported, imports ran at an annual rate of $24 billion, about 12 per cent above 1965 imports of $21.4 billion.

As the first part of this Letter is being typed (noon, Wednesday, May 4) the Averages are down again for the eighth out of nine trading sessions. Industrials are a few points above 911.08 (the bear signal level), Rails are two points above 243.60 (the bear signal level) and Utilities are already at a new low. The outcome of today's action cannot be known at this time, and I will finish the Letter and make comments tomorrow after the opening (this is my deadline before taking the Letter directly to the printer).

SOME FUNDAMENTALS: Many of the economic manifestations now being witnessed are characteristic of a cyclical top. Students of the business cycle, aware of this, are not viewing the current "glowing business statistics" with the kind of enthusiasm which might otherwise be expected. For instance:

Figures for all catagories of retail sales for the first quarter were up 4.6% over the preceding quarter or up 18% on an annualized basis. A large part of this rise stemmed from the consumer sector of the economy. Yet personal income (after taxes) has risen at an annual rate of 7.7%, and starting this month the withholding tax is slated to cut into take-home pay. Thus the rise in sales cannot be expected to continue at 18% in the face of a 7.7% or less rise in personal income. The April drop in auto sales, in fact, could be the first "straw in the wind."

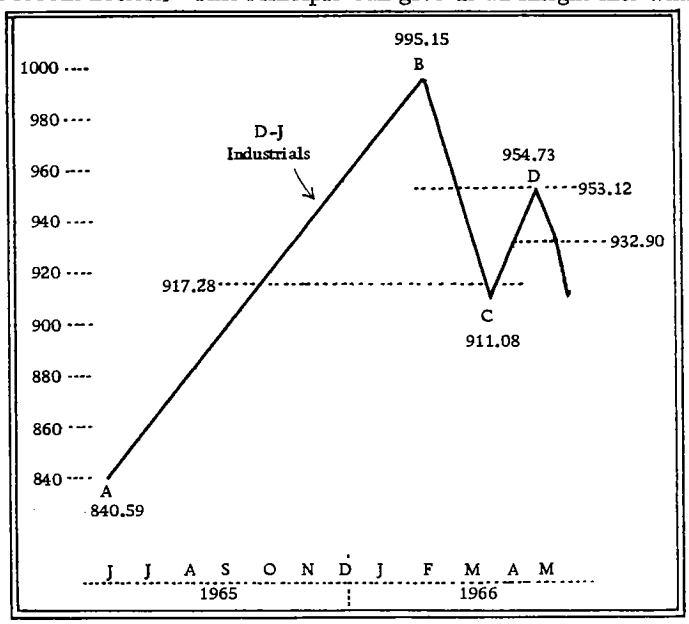
The non-durable goods sector showed a quarter to quarter rise of 16% at the end of the first quarter. This reflects a big jump in defense spending, but defense spending is expected to level off in the second half of this year. Nevertheless, this type of abnormal spending is indicative of an advanced stage in the business cycle. It suggests a "white hot" state of optimism, a psychology which is usually quite transitory. It should be remembered that capital spending is usually highest at the top of a business boom.

Operating costs and expenses are now rising. Latest figures show that the operating profit margin (before income taxes) of all manufacturers dropped from 9.8% to 9.2% between the second quarter of 1965 and the fourth quarter. The termination of the rise in profit margins is indicative of the end of a major rise in the business cycle.

Interest rates in all segments of banking and industry are pushing steadily higher, and this too is characteristic of the terminal stages of a boom. Almost daily the financial pages feature news of a new rise in interest rates in some particular segment of the economy. The struggle for money at the retail level is now the fiercest in a generation, with the "advantage" going first to savings & loans, then to banks, then to large corporations but ultimately to the biggest borrower of all, the Goverment. The projected sale of Goverment loans (as outlined by President Johnson) at interest rates of 5.5% or more could represent the greatest threat yet to financial liquidity.

Stocks have been rising in many cases on the theory that equity constitutes the best "inflation hedge." The second argument is that earnings are continuing to surge in the current heated economic atmosphere. But there is evidence to suggest that earnings have been discounted fully by the market in most cases. Furthermore, against a background of rising interest rates it is dangerous to count on a continuation of inflation. Finally, it should be remembered that a good many of the fat earnings statements now being released by corporations are a result of temporary excess. It is extremely doubtful, for instance, whether the current surge in color TV sales can be maintained. But it is characteristic near a cyclical top for analyst and the public to accept the abnormal as a way of life and project the trend of excesses into the future in the form of "super-excesses."

50% PRINCIPLE: I have discussed the 50% Principle frequently in recent Letters. This Principle can give us an insight into what has been happening in the market over the past few months. The 50% Principle states that the movements of any broad average can be likened to a child's see-saw, and what the average does at the halfway (50% level) of a preceding advance or decline may therefore be significant.



The accompanying diagram will help readers follow the implications of the 50% Principle. The reaction which set in during February-March, 1966 (B-C on diagram) halted at 911.08. This was below the 917.28 or halfway level of the entire 1965-1966 (A-B) rise. In other words, the reaction B-C, instead of halting bullishly above 917.28, continued and thereby erased 54% of the ground gained on the major upward leg A-B.

The fact the Industrial Average at point C had wiped out more than half of the gains established during the A-B rise held bearish connotations.

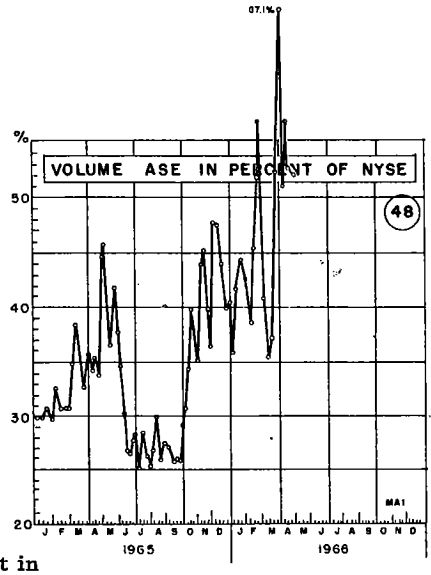
The next question was how would the Industrial Average do on the recovery from C to D. The halfway level from B to C was 953.12. If Industrials could close and hold decisively above 953.12 (or gain better than half the ground they had lost), the 50% Principle was saying they might yet approach or better the high at B. On April 21 Industrials rallied to 954.73. Thus, for a single day they held by the barest fraction above the 50% level. But the next trading day saw the market start down again.

Now the question was, having failed to retain 50% of the A-B gains and having failed to rally decisively above the halfway level of B-C, would Industrials at least be able to hold half of their C-D gains? The halfway point of the feeble C-D rally was 932.90. On May 2 the Industrial Average sank below that level, thus giving back better than half of the gains registered during the C-D recovery.

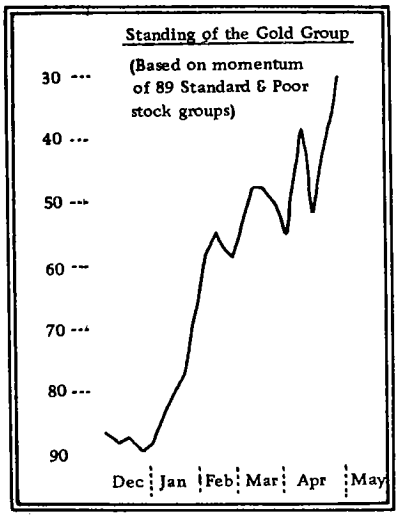
The downside penetration of 932.90, the halfway point of the C-D rise, represented the third failure of Industrials since 1965 under the 50% Principle. The implications were that the market "pendulum" would approach and test the March low again (911.08). Failing to hold above 911.08, the pendulum should move lower and test the 1965 low of 849.59.

CHART OF THE WEEK: One of the best gauges of speculative sentiment is the ratio of volume on the N.Y.S.E. and volume on the American Exchange. The chart on page 4 (courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514) gives us a picture of this ratio as of last week. A ratio of 25 to 30% might be considered normal, but lately the ratio has surged up to a high a few weeks ago of 67%. It is still in the area of 50% or above, indicating abnormal speculative sentiment on the Amex. This despite liquidation in the investment grade issues. Prognosis.....dangerous.

GOLD: When the bear growls, men's fancies turn to thoughts of gold. The chart at right tells an interesting story. Each week Chartcraft (Larchmont, N.Y.) tabulates 89 Standard & Poor's stock groups based on group momentum through a 17 week cycle. Unnoticed to most investors, the gold group has quietly been climbing higher (on the basis of the Chartcraft tabulations). The figures for April 27 show golds at their highest rating for the year at 29. The strength in the group is beginning to be reflected in individual stocks such as American South African (which rose to within 3 points of its all-time high last week) and Dome (which rose to 40, or 10% from its high last week). I continue to recommend purchase and retention of gold shares.



LATE NOTES: (Written after the opening, Thursday, May 5)...The market continued to fall yesterday with no particular news to account for the weakness. The action produced a good deal of damage (164 new 1966 lows), although Industrials recovered half of their 12 point intra-day loss at the close. The liquidation of quality stocks continued. The advance-decline ratio has now dropped to within a fraction of its July, 1965 level, at which time the Dow stood at 860. At yesterday's close the Utility Average stood at 138.90, a new low for the year. Since Utilities tend ro reflect the movements of investment money, I consider this to be an ominous sign for the market in general (see last Letter). Actually, if investment money was going to return to Wall Street, I would think that Utilities would be one of the first groups they would buy.



Finally, the D-J 40 Bond Average quietly sank to a new low for the year at 84.28 (any broad bond index will tend to decline during a primary bear market.). The new lows in bonds and utilities suggests a continuation of informed selling. The most bearish single force on any market is a steady liquidation of securities by large investment interests. It is for this reason that I attach importance to the new 1966 lows in bonds and utilities. (It is also of interest that Barron's Confidence Index broke to 95.0 last week, lowest level in two years, and indicative of the ebbing of confidence in informed circles).

Under Dow Theory, a primary bear market cannot be signalled until or unless both Industrials and Rails close under 911.08 and 243.60 respectively. Will they do this? There is not a man alive who knows with certainty. What is my guess? I am guessing that a primary bear market did start on February 9 and that in due time a bear signal will be rendered. At yesterday's closing, the Dow was down on 8 out of 9 days. It could rally from here—perhaps halfway back to its 954.73 April recovery high, perhaps higher. The market will take its own good time in rendering its verdict.

Past history suggests that once a bull market has hit its final peak, each rally thereafter is weaker than the last—until finally the bear signal is given. If a bear market has started, each day is bringing us closer to the ultimate bear signal with its probable aftermath of panic and tragic losses. As investors, it behooves us not to get caught in the vortex of deceptive trading rallies and belated speculative fever. I continue to recommend a highly liquid cash position for all my subscribers.

STOCKS: In the past few Letters I have been stressing the ominous implications of the steady selling in the Dow stocks. These thirty stocks comprise 37% of the value of the N.Y.S.E.; they are the giants that reflect basic changes in the U.S. economy. As of today, only 6 of the 30 stocks are still bullish (Alcoa, Amer. Tob., East. Kodak, Goodyear, Int. Nickel, Int. Paper). This is a mere 20%! On May 4 no less then 10 Dow stocks (one third of the list) hit new 1966 lows. I call it real liquidation.

Here is a continuation of my review of the thirty Dow stocks, started in Letter 320. It is perhaps significant that only one of these six stocks (St. of Calif.) touched a new high in 1966. All of these six stocks are in bear trends. They are not reflecting conditions today, but they are discounting conditions as informed investors see them six months or a year from now (charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).